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Supreme Court of the United States

OCTOBER TERM, 1948.

No. 442.

HANNAH COHEN, Executrix of the Estate of Sol Cohen, Deceased, and David F. Cohen, Intervenor,

Petitioners,

—against—

BENEFICIAL INDUSTRIAL LOAN CORPORATION,

Respondent,

—and—

C. W. CASPERSEN, JOHN BUDD SMITH, ROY E. TUCKER, EVERETT T. FELTER, JACKSON R. COLLINS, C. V. SMITH, E. L. KINCAID, ALBERT G. MORHART, RAYMOND D. SHEPARD, ALFRED G. ZIMMERMAN, FRED C. EIBELL, RICHARD K. STEINMAN and PAULA A. SEIBOLD, individually,

Defendants.

No. 512.

BENEFICIAL INDUSTRIAL LOAN CORPORATION,

Petitioner,

—against—

Honorable William F. Smith, a Judge of the United States District Court for the District of New Jersey; and HANNAH COHEN, Executrix of the Estate of Sol Cohen, deceased, and David F. Cohen, Intervenor,

Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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Respondents.

BRIEF FOR PETITIONERS IN NO. 442, O.T. 1948—BRIEF FOR RESPONDENTS HANNAH COHEN AND DAVID F. COHEN IN NO. 512, O.T. 1948.

Opinions Below.

The opinion of the District Court (R. 22) is reported at 7 F.R.D. 352. The opinion of the Court of Appeals for the Third Circuit (R. 30) is reported at 170 F. 2d 44.

Jurisdiction.

The judgment of the Court of Appeals for the Third Circuit, reversing the order of the District Court and remanding the cause, was entered on September 22, 1948. The petition for a writ of certiorari in No. 442 was filed December 2, 1948 and was granted February 28, 1949.

The judgment of the Court of Appeals for the Third Circuit dismissing the petition for a writ of certiorari or a writ of mandamus was entered on September 22, 1948. Following an order by Mr. Justice Burton extending the time, the petition for a writ of certiorari in No. 512 was filed January 14, 1949 and was granted February 28, 1949.

Statutes Involved.

The statutory provisions involved are set forth in Appendix A, pages 36-38.

Statement.

The controversy at bar arises out of a derivative stockholder's action brought against the individual defendants on behalf of the respondent [1] Beneficial Industrial Loan Corporation, a Delaware corporation. Jurisdiction of the District Court for the District of New Jersey was based upon diversity of citizenship. The complaint, originally on behalf of Sol Cohen, was filed on August 9, 1943 (R. 1). On August 23, 1943, David F. Cohen was permitted to intervene as party-plaintiff (R. 1). On February 14, 1946, following the death of Sol Cohen, Hannah Cohen, his executrix, was

[1] The parties will be designated herein by their titles in No. 442, *i.e.*, plaintiffs in the District Court will be referred to as "petitioners" and Beneficial Industrial Loan Corporation will be referred to as "respondent."

substituted in his stead (R. 5). The petitioners own 250 shares of the common stock of the corporate defendant (R. 11).

It is unnecessary to set forth here the allegations contained in the original and amended complaints. It suffices to state that serious and sizable defalcations by the officers and directors of Beneficial Industrial Loan Corporation are alleged. Nor is it necessary to detail the various procedural maneuvers which took place between the time of the filing of the original complaint in August, 1943 and the motion for security for costs made by the respondent corporation in August, 1946, except to say that there had been lengthy pre-trial discovery proceedings. The only issues now before the Court arise out of or relate to that motion.

That motion was for an order directing that

> "the plaintiff and the intervener give security to defendant Beneficial Industrial Loan Corporation in the amount of not less than $125,000 for the reasonable expenses, including counsel fees, which may be incurred by said defendant in connection with this action, and for the reasonable expenses, including counsel fees, which may be incurred by the other parties defendant in connection therewith for which defendant Beneficial Industrial Loan Corporation may become subject pursuant to law or to its by-laws [2] or under equitable principles * * *." (R. 9)

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[2] Article X of the by-laws of Beneficial Industrial Loan Corporation provides in part:

"The Corporation shall indemnify and hold harmless each person who shall serve at any time hereafter as a director or officer of the Corporation from and against any and all claims and liabilities to which such person shall have become subject by reason of his having heretofore or hereafter been a director or officer of the Corporation, or by reason of any action alleged to have been heretofore or hereafter taken or omitted by him as such director or officer, and shall reimburse each such person for all legal and other expenses reasonably incurred by him in connection with any such claim or liability; provided, however, that no such person shall be indemnified against, or be reimbursed for any expense incurred in connection with, any claim or liability arising out of his own negligence or wilful misconduct. The rights accruing to any person under the foregoing provisions of this Article shall not exclude any other

The motion was based on Chapter 131 of the New Jersey Laws of 1945 (N. J. R. S. Cum. Supp. 14:3-15, 14:3-17). See pp. 36-37, *infra*.

Judge Smith denied the motion and stated in his opinion that the provisions of Chapter 131 were inapplicable to this litigation in a federal court and that, in any event, the law of Delaware, rather than that of New Jersey, would be governing as to the petitioners' liability for the respondent's expenses and counsel fees. The respondent appealed from the decision of Judge Smith to the Court of Appeals for the Third Circuit. At the same time the respondent petitioned that Court for a writ of certiorari or of mandamus.

The Court of Appeals held that the order of the District Court denying security for costs was appealable. Having determined that it possessed jurisdiction over the appeal, the Court held that the provisions of Chapter 131 here at issue were enforceable in a federal court, that they were constitutional under the federal and New Jersey Constitutions, and that the retroactive application was not violative of either Constitution. The Court of Appeals also held that the petitions for certiorari or mandamus should be dismissed. Petitions for certiorari were filed by both the plaintiffs and the corporate defendant, and both petitions were granted.

Questions Presented.

1. Whether the order of the District Court for the District of New Jersey, denying the corporate defendants' motion for security for costs and counsel fees, was appealable.

2. Whether the order of the District Court denying the corporate defendants' motion for security for costs and counsel fees was reviewable by the Court of Appeals upon a petition for writ of mandamus or certiorari.

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right to which he may be lawfully entitled, nor shall anything herein contained restrict the right of the Corporation to indemnify or reimburse such person in any proper case even though not specifically herein provided for. The Corporation, its directors, officers, employees and agents, shall be fully protected in taking any action or making any payment under this Article X or in refusing so to do, in reliance upon the advice of counsel." (R. 10)

3. Whether a federal court in New Jersey, whose jurisdiction is based upon diversity of citizenship, must apply the laws of New Jersey with respect to security for costs and counsel fees, in a derivative stockholders' action brought by a New York stockholder on behalf of a Delaware corporation.

4. Whether Chapter 131 of the New Jersey Laws of 1945, particularly N. J. R. S. Cum. Supp. 14:3-15 and 14:3-17, if applicable to a federal court whose jurisdiction is based upon diversity of citizenship, violates the federal Constitution.

5. Whether in its application to actions commenced prior to its enactment Chapter 131 of the New Jersey Laws of 1945, particularly N. J. R. S. Cum. Supp. 14:3-15 and 14:3-17, if applicable to a federal court whose jurisdiction is based upon diversity of citizenship, violates the federal Constitution.

Summary of Argument.

The court below was in error in reviewing the order of the District Court denying security for expenses and attorneys' fees. That order was not a final judgment, nor was it appealable under any exception to the final judgment rule. Not having jurisdiction over any appeal, the Court of Appeals could not—probably as a matter of power and certainly as a matter of discretion—review the order by writ of mandamus.

The District Court was correct upon the merits of the case. Chapter 131 is not applicable to a federal court. In the first place, it is "procedural" under the *Erie R. R.* v. *Tompkins* rule. In the second place, the New Jersey statutes are directed to the question of good faith of plaintiffs in bringing derivative actions; Congress and this Court have already created a system to assure plaintiffs' integrity in maintaining such suits: Rule 23 of the Federal Rules of Civil Procedure.

If, however, the provisions of Chapter 131 at issue are held to be binding on a federal court, this Court must hold that they violate the equal protection and the due process clauses of the federal Constitution as being discriminatory as between plaintiffs, an undue burden on the right of certain litigants to invoke the judicial process, grossly unfair, and completely and unreasonably unrelated to the supposed evils of derivative suits. Moreover, the full faith and credit clause requires the application of Delaware and not of New Jersey law, Delaware being the state of incorporation and the source of the rights sued upon.

But apart from their general unconstitutionality, the provisions of the law at issue here, because of their retroactivity, violate the due process clause of the Fourteenth Amendment and the contract clause. They represent an effort, unique in the history of this Court, to deprive some but not all similarly situated suitors of a cause of action already invoked.

ARGUMENT.

I. THE ORDER DENYING RESPONDENT'S MOTION FOR SECURITY FOR COSTS WAS NOT APPEALABLE.

The constitutional and federal issues presented by this case are difficult and sensitive of solution. They would never have arisen had not the Third Circuit overextended its reach. This litigation thus presents a practical illustration of the wisdom of the final judgment rule: the incidental issues here presented will have taken almost three years to resolve, while the merits of the suit remain unconsidered.

The threshhold question thus goes to the jurisdiction of the Court of Appeals to entertain so obviously an interlocutory order as that of the District Court denying respondent's motion for security for costs. Contrary to the holding of the

Second Circuit,[3] the Third Circuit ruled that the order was a "final decision" and, therefore, appealable.

The limitation of review by the Court of Appeals to "final decisions" of the District Courts is statutory and jurisdictional. 28 U. S. C. § 1291. The question of what is a "final decision" and the policy of Congress behind the rule has been set forth in many opinions of this Court.

> "Finality as a condition of review is an historic characteristic of federal appellate procedure. It was written into the first Judiciary Act and has been departed from only when observance of it would practically defeat the right to any review at all. Since the right to a judgment from more than one court is a matter of grace and not a necessary ingredient of justice, Congress from the very beginning has, by forbidding piecemeal disposition on appeal of what for practical purposes is a single controversy, set itself against enfeebling judicial administration. Thereby is avoided the obstruction to just claims that would come from permitting the harassment and cost of a succession of separate appeals from the various rulings to which a litigation may give rise, from its initiation to entry of judgment. To be effective, judicial administration must not be leaden-footed. Its momentum would be arrested by permitting separate reviews of the component elements in a unified cause. * * * *"
>
> "In thus denying to the appellate courts the power to review rulings at *nisi prius*, generally, until after the entire controversy has been concluded. Congress has sought to achieve the effective conduct of litigation. For purposes of appellate procedure, finality—

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[3] *Thompson* v. *Broadfoot & Aspinook Corporation* (2d Cir., 1947). The case is unreported, but referred to in *Aspinook Corporation* v. *Bright*, 165 F. 2d 294, 295 (2d Cir., 1948). The entire opinion in the *Thompson* case reads: "Motion granted on the ground that the appeal from the order must be dismissed because the order is not final." Judge Frank noted his dissent from this decision in which Judges A. N. Hand and Clark participated.

> the idea underlying 'final judgments and decrees' in the Judiciary Act of 1789 and now expressed by 'final decisions' in § 128 of the Judicial Code—is not a technical concept of temporal or physical termination. It is the means for achieving a healthy legal system. As an instrument of such policy the requirement of finality will be enforced not only against a party to the litigation but against a witness who is a stranger to the main proceeding. Neither a party nor a non-party witness will be allowed to take to the upper court a ruling where the result of review will be 'to halt in the orderly progress of a cause and consider incidentally a question which has happened to cross the path of such litigation. . . .' Mr. Chief Justice Taft, in Segurola v. United States, 275 U. S. 106." *Cobbledick* v. *United States*, 309 U. S. 323, 324-25, 326 (1940).

And again in *Catlin* v. *United States*, 324 U. S. 229, 233 (1945), this Court stated its definition: "a 'final decision' generally is one which ends the litigation on the merits and leaves nothing for the Court to do but execute the judgment."

Little need be said to demonstrate that the order denying the motion for security for costs fulfills none of the requirements of a "final decision." To evade the patently applicable principles which demonstrate the absence of jurisdiction in the Court of Appeals, however, respondent urges that the order finally resolved an entirely separable controversy unrelated to the rest of the case. But in seeking to invoke the support of cases holding completely separable controversies appealable, it chooses to overlook the fundamental factor existent in those cases but not in this one: that the question must be so distinct and unrelated to the other issues in the case that further proceedings in the trial court can have no effect on the question sought to be appealed. The question raised by respondent's appeal, however, is so intertwined with the merits that it may be rendered moot by

later action of the trial court. For in the event the plaintiffs prevail on the merits no question of liability for costs need be considered.

Respondent has cited cases allegedly in support of its separable controversy position. But in none of the cases heretofore cited by the respondent could further action in the trial court have any impact on the questions appealed. For example, in *Sprague* v. *Ticonic Bank*, 307 U. S. 161 (1939) no further proceedings in the trial court were possible; the substantive issues in the litigation had previously been resolved. In *United States* v. *River Rouge Improvement Co.*, 269 U. S. 411 (1926) further proceedings as to other owners could not moot or otherwise affect the awards in appeal. "The controversy as to the gas main is entirely distinct from those as to riparian lands; and its result can have no bearing whatsoever upon the awards to the landowners." *Id.* at 413-414. In *Ex parte Tiffany*, 252 U. S. 32 (1920) nothing in the further action by the trial court could have impact on whether the state receiver or federal receiver was to retain the property. In *Gumbel* v. *Pitkin*, 113 U. S. 545 (1885) no matter what the trial proceeded to resolve, the question presented by the intervener would have to be decided. And in *Trustees* v. *Greenough*, 105 U. S. 527 (1882), the award of fees was not subject to change by reason of the subsequent conduct of the case in the trial court.

Trustees v. *Greenough*, *supra*, so heavily relied upon by both the respondent and the Third Circuit is irrelevant for additional reasons. *Greenough* related to costs, not security, as does this case. The decision in *Greenough* granted an absolute and immediate right to the costs awarded, while in this case the right to costs, if any, and the amount thereof, are contingent on further events at the trial. And finally the order at bar is a denial of security—not a grant, so that even if we assume that an order granting security, like an order granting summary judgment, is appealable, an order denying such security is not, since it resolves no controversy, stays no proceedings and may ultimately be reviewed on appeal.

What respondent is contending here is that the District Court order deprives it of reimbursement for counsel fees and expenses for which it may never be liable and to which it may never be entitled. The lack of "finality" in such a decision is self-evident. In the event no security is required of petitioners and final judgment is in favor of the defendants, the respondent will then be able to appeal from the District Court judgment should it deny respondent a right to reimbursement for counsel fees and expenses.[4] Should the Court of Appeals at that time rule that the respondent is entitled to reimbursement for counsel fees and expenses, it can eliminate the contrary "final judgment" of the District Court, which respondent looks upon as a potential bar to its recovery.

The wisdom of the "final decision" rule is made evident by the very terms of the New Jersey statute under attack here. For if the denial of security is an independent decision, so too on the reasoning of respondent and the Third Circuit, would be an order fixing the amount of the security or amending or refusing to amend it. The necessary consequences of numerous interlocutory appeals may be a parade of horribles, but they are not imaginary.

II. MANDAMUS IS NOT AVAILABLE TO REVIEW THE DENIAL OF THE MOTION FOR SECURITY FOR COSTS.

Inasmuch as the order denying security for costs was not appealable, the Court of Appeals properly refused to grant mandamus.

The use of extraordinary writs lies in an area where power and discretion merge. This Court has held that an intermediate federal court can grant auxiliary writs only when there is an appellate proceeding pending in the court. *Whit-*

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[4] *Newton v. Consolidated Gas Co.*, 265 U. S. 78 (1924); *Mason v. Pewabic Mining Co.*, 153 U. S. 361 (1894); *Watling v. Norfolk Southern Ry. Co.*, 162 F. 2d 95 (4th Cir., 1947); *Harris v. Twentieth Century Fox Film Corporation*, 139 F. 2d 571 (2d Cir., 1943).

ney v. *Dick*, 202 U. S. 132 (1906); *Adams* v. *United States*, 317 U. S. 269 (1942).[5] The one stated exception to this rule is that where the action of the trial court might otherwise defeat the right of the Court of Appeals to review a case, mandamus may be granted. "Otherwise the appellate jurisdiction could be defeated and the purpose of the statute authorizing the writ thwarted by unauthorized action of the district court obstructing the appeal." *Roche* v. *Evaporated Milk Ass'n.*, 319 U. S. 21, 25 (1943) and cases cited.

Yet despite the clarity of the rule and the logic of its exception into which this case does not fall, cases can be found where the Court has held that the Court of Appeals had *power* to grant mandamus, although no appeal had been taken and although no appellate jurisdiction would have been frustrated. Such a case indeed is *Roche* v. *Evaporated Milk Ass'n.*, *supra*, and *Ex parte Peru*, 318 U. S. 578 (1943) also assumes power in the Court of Appeals. But see *United States* v. *Bondy*, 174 F. 2d 642 (2d Cir., 1948), denying the existence of such power.

Whether the Court of Appeals possessed power in the strict sense is, therefore, questionable. The impropriety of the exercise of that power, however, is not.

Mandamus, as an extraordinary remedy, is "reserved for really extraordinary causes." *Ex parte Fahey*, 332 U. S. 258, 260 (1947). "[W]here, as here the statutory scheme permits appellate review of interlocutory orders only on appeal from the final judgment, review by certiorari or other extraordinary writ is not permissible in the face of the plain indication of the legislative purpose to avoid piecemeal reviews." *United States Alkali Export Ass'n* v. *United States*, 325 U. S. 196, 203 (1945) and cases cited.

At the most the action of the District Court was "a mere error in the exercise of conceded judicial power", not "usurpation of power". *De Beers Consolidated Mines* v. *United States*, 325 U. S. 212, 217 (1945). As such, it can be corrected upon appeal. To be sure, if the defendant wins

[5] A similar limitation does not bind this Court. See *Los Angeles Brush Manufacturing Corp* v. *Jones*, 272 U. S. 701 (1927); *Ex parte Peru*, 318 U. S. 578, 590 (1943). *Whitney* v. *Dick* may explain why a narrower power is imputed to the intermediate federal courts.

and if the District Court does not impose expenses and attorneys' fees upon the petitioners, the defendant may be forced to appeal so much of the decision of the District Court that denies it the right to expenses and attorneys' fees.[8] "But that inconvenience is one which we must take it Congress contemplated in providing that only final judgments should be reviewable. Where the appeal statutes establish the conditions of appellate review an appellate court cannot rightly exercise its discretion to issue a writ whose only effect would be to avoid these conditions and thwart the Congressional policy against piecemeal appeals * * *." *Roche* v. *Evaporated Milk Ass'n*, *supra*, at 30. Indeed, in the *Roche* case itself the possibility of a lengthy and expensive criminal trial was held not to justify mandamus.

Nor is mandamus available because the respondent will not have been given security for its expenses and attorneys' fees. The extreme contingency that *if* plaintiffs lose their case and *if* it is held that they are assessable for expenses and attorneys' fees, that they may not be able to satisfy that liability cannot justify interference with the trial of this case by interlocutory and extraordinary proceedings; just as mandamus would not be justified to review a denial of a plaintiff's motion for summary judgment upon a claim that defendant might be insolvent by the end of the case. To grant mandamus on this ground would mean that if a court did grant security, but the corporate defendant felt it was not sufficient, efforts would be made to obtain a writ of mandamus from a higher court to force an increase. Such a holding would result in exactly that kind of interference with trials that the final judgment rule and the limitation upon extraordinary writs were intended to avoid. As the Second Circuit stated in *Aspinook Corporation* v. *Bright*, 165 F. 2d 294, 295 (2d Cir. 1947), "[T]here seems no occasion to call into play this extraordinary remedy and thus invite continued resort to it for various and sundry steps preliminary to trial which a litigant finds expensive or otherwise

[8] See cases cited n. 3, *supra*.

disturbing." The decisions of this Court, reviewed in the *Roche* case, fully justify this statement and the holdings of the Second Circuit and the Court below denying mandamus.

III. N.J.R.S. CUM. SUPP. 14:3-15, 14:3-17 ARE NOT APPLICABLE IN A FEDERAL COURT.

It is important to note, at this time, the two distinct questions underlying the issues in this aspect of this case. The first is whether a federal court, in a diversity case, must follow the procedure of requiring security to be posted in advance to which the corporation might be able to look for costs and attorneys' fees in the event that the individual defendants prevail in the action. The second is whether the federal court must award a corporation costs and expenses upon the failure of the plaintiffs to prove their cause of action. The questions are distinct for the reason that even if a plaintiff might ultimately be liable for fees and expenses by reason of the New Jersey statute, the New Jersey procedure of providing security from which those fees and expenses would be paid would not have to be adopted. Only if the Court should rule that the first question must be answered in the affirmative need it look to the second. If the Court rules, as it should, that the posting of security in advance is a procedural matter not binding on a federal court the second question need not now concern it.

Whether a bond is to be posted in advance is clearly a question which, even in diversity cases, is not controlled by state rules. Although we recognize that recent decisions of this Court, such as *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945) and *Angel* v. *Bullington*, 330 U. S. 183 (1947) command enforcement of state policies by federal courts, in the *York* case itself this Court pointed out that federal courts need not follow state law when what the state statute concerns is "merely the manner and the means by which a right to recover, as recognized by the State, is enforced * * *." 326 U. S. at 109. The time when petitioners should put up

moneys to which the respondent might eventually be entitled is certainly to be left to the discretion of the forum.

No one, to be sure, is so unsophisticated as to argue that state regulations of its processes of trials and appeals have no effect upon litigation. A state, by procedural regulation, can encourage or discourage general or particular types of litigation. It is not the doctrine of *Erie R. R.* v. *Tompkins*, 304 U. S. 64 (1938), however, that a federal court must enforce all the obstacles a state places in the way of enforcement of a substantive right.

> "State law cannot define the remedies which a federal court must give simply because a federal court in diversity jurisdiction is available as an alternative tribunal to the State's courts. Contrariwise, a federal court may afford an equitable remedy for a substantive right recognized by a State even though a State court cannot give it." *Guaranty Trust Co.* v. *York*, 326 U. S. 99, 106 (1945).

The policy underlying the *Erie R. R.* case is that the result on the merits should not be different. In all the cases since the *Erie* decision which have come before this Court, the federal court, had it not followed the state rule, might have reached a different result on the merits than that which would have been reached in the state court. Rules as to burden of proof, *Cities Service Oil Co.* v. *Dunlap*, 308 U. S. 208 (1939), conflict of laws, *Klaxon Co.* v. *Stentor Electric Mfg. Co.*, 313 U. S. 487 (1941), contributory negligence, *Palmer* v. *Hoffman*, 318 U. S. 109 (1943), statutes of limitation, *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945), and res judicata or jurisdiction, *Angel* v. *Bullington*, 330 U. S. 183 (1947), all might mean the difference between a judgment for the plaintiff and one for the defendant. But a rule as to security cannot possibly affect the outcome of a trial. See *Boyd* v. *Bell*, 64 F. Supp. 22 (S. D. N. Y. 1945).

Respondent refuses to separate the questions of security and the right to reimbursement for counsel fees and ex-

penses—though they will necessarily have to be decided at widely separated times. It contends that unless security is posted when the respondent moves for it, it can not secure reimbursement. No authority is advanced for this position; none exists. A reading of the New Jersey statute—on the issue of whether respondent can be entitled to such reimbursement—certainly does not preclude the awarding of such expenses in the judgment on the merits, if the court determines such expenses are due.

Thus far, we have spoken only of the New Jersey provisions relating to security; for they are, in our opinion the only ones at issue at this time in so far as their enforcement in a federal forum is concerned. But what is true of the security provisions is also true of the provisions of New Jersey law which authorize imposing upon a losing plaintiff liability for the defendants' expenses and attorneys' fees. These provisions similarly cannot affect the merits of the litigation.

It is true that in certain instances the federal courts have applied state statutes relating to attorneys' fees. See *Sioux County* v. *National Surety Co.*, 276 U. S. 238 (1928) and cases cited. But, as Judge Smith pointed out, these cases "are easily distinguishable from the present case." In all of them "the liability of the defendant for attorneys' fees and costs was a statutory liability assumed by the defendant under contract, and the right of the plaintiff to their recovery was absolute * * *." 7 F. R. D. at 356. No such contractual obligation can be spelled out here, especially since the suit itself was begun years before the statute was enacted.

Any remaining doubt as to the applicability of the New Jersey statute to the federal courts is completely dissipated by the provisions of Rule 23 of the Federal Rules of Civil Procedure. Chapter 431 is directed to the good faith of plaintiffs in bringing derivative actions. Congress and this Court in Rule 23 have already provided against bad faith and other abuses in derivative actions. Rule 23 insures adequate representation in stockholders' actions, safeguards against lack

of good faith by requiring a verified complaint, outlaws the purchase of stock in order to bring suit by requiring that the plaintiff be a shareholder at the time of the transaction of which he complains, prevents secret and unfair settlements by forbidding dismissal without the approval of the District Court and dismissal or compromise without notice. Thus, it has been affirmatively indicated that for the purpose of the Rules of Decisions Act, 28 U. S. C. § 1652 and *Erie R. R. v. Tompkins*, 304 U. S. 64 (1938), federal law, not state law, shall be governing. Indeed, Rule 23 is an "Act of Congress" within the meaning of the Rules of Decisions Act. See *Sibbach v. Wilson & Co.*, 312 U. S. 1, 15-16 (1940).

If state law were held governing, it would mean that Rule 23, in so far as it regulates stockholders' actions, is invalid, for the Rule would necessarily be dealing with matters of substance rather than procedure. See 3 Moore's Federal Practice (2d ed.) 3496. Yet the presumption of the validity of Rule 23 is very strong. As stated in *Sibbach v. Wilson & Co.*, *supra*, at 15-16:

> "The value of the reservation of the power to examine proposed rules, laws and regulations before they become effective is well understood by Congress. It is frequently, as here, employed to make sure that the action under the delegation squares with the Congressional purpose. Evidently the Congress felt the rule was within the ambit of the statute as no effort was made to eliminate it from the proposed body of rules * * *. That no adverse action was taken by Congress indicates, at least, that no transgression of legislative policy was found. We conclude that the rules under attack are within the authority granted."

The validity of Rule 23 has been many times sustained. See cases collected in 3 Moore's Federal Practice (2d ed.) 3496, n. 18; see also Hsen, *Monographs on Recent Developments and Trial and Appellate Practice* (1947) contained in Federal Rules of Civil Procedure With Approved Amendments (West Publishing Co. ed. 1947) 333.

Moreover, it cannot be argued that though Rule 23 governs such matters as whether a plaintiff must own stock at the time of injury, since it does not specifically refer to security and liability for expenses, the New Jersey statutes may nevertheless be applicable. It is clear that Rule 23 is a comprehensive scheme of regulating the abuses of stockholders' suits.[7] The field has been totally occupied by the federal government, and the states may not superimpose their own regulations. Or to put the matter differently, the federal government has characterized its rule as procedural and, therefore, conflicting or similar state statutes or rules must be similarly characterized for purposes of the *Erie* doctrine. As Judge Magruder said in *Sampson* v. *Channell*, 110 F. 2d 754, 756-57 (1st Cir., 1940), "There will be, inescapably, a twilight zone between the two categories [substance and procedure] where a rational classification could be made either way, and where Congress directly, or the Supreme Court under authority of the Act of June 19, 1934, 48 Stat. 1064, 28 U. S. C. A. §§ 723b, 723c, would have power to prescribe a so-called rule of procedure for the federal courts."

The corporation also suggests that Chapter 131 should have been applied in the District Court by virtue of Local Rule 15 of that Court.[8] Since Rule 23 of the Federal Rules of Civil Procedure occupies the field, Local Rule 15 is inoperative. Federal Rules Civil Procedure, Rule 83. Even if Rule 23 is not governing, it is not the function of local district court rules to resolve problems arising under the *Erie* doctrine. To permit each district court to choose for itself, would mean, for example, that in a state such as

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[7] That part of the Rule relating to ownership is derived from *Hawes* v. *Oakland*, 104 U. S. 450 (1882); see 1946 Note of the Advisory Committee to Rule 23. Other aspects of the Rule 23, contemplating "the compromise of stockholders' suits under proper supervision of the Court," incorporate a public policy. *Hinkelman* v. *General Motors Corp.*, 48 F. Supp. 504, 514 (S. D. N. Y. 1942).

[8] "In circumstances not provided for by the Federal Rules of Civil Procedure or by these rules, the procedure and practice of the Courts of the State of New Jersey shall govern."

New York which has more than one judicial district, each district would decide for itself whether to apply Section 61-b of the New York General Corporation Law.

IV. N.J.R.S. CUM. SUPP. 14:3-15 AND 14:3-17 VIOLATE THE FEDERAL CONSTITUTION.

The constitutional issues to which the remainder of the brief is devoted need be reached only if the Court rejects the petitioners' contentions heretofore made. There are, in fact, two sets of constitutional questions. In this section of the brief we shall discuss whether, apart from the retroactive effect of Chapter 131, the provisions of that chapter violate the federal Constitution. In the next section, we shall discuss the retroactive features of the legislation.

A. The Functions of the Derivative Action.

Stockholders' derivative actions have been firmly established as an integral part of Anglo-American jurisprudence for more than a century. *Hichens* v. *Congreve,* 4 Russ. 562, 38 Eng. Rep. 917 (Ch. 1828); *Dodge* v. *Woolsey,* 18 How. 331, 341-42 (1856). They have been an essential element in restraining the overreaching of corporate fiduciaries. The large amounts of corporate moneys received from derelict fiduciaries in actions of this type bear witness to the essential functions which these actions perform in protecting the investing public. Some of the recoveries in recent years, all involving publicly owned corporations, are compiled in Appendix "B".

Nor are the actual recoveries a full measure of the social benefits of stockholders' suits. As a deterrent to the greedy and a spur to the neglectful corporate fiduciary, they accomplish more by way of prophylaxis than redress.

> "Despite the numerous abuses which have developed in connection with such suits they have accomplished much policing the corporate system, especially in pro-

> tecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. * * * The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders." Rifkind, *J.*, in *Brendle* v. *Smith*, 46 F. Supp. 522, 525-26 (S. D. N. Y. 1942).

The stockholders' suit is not only valuable, it is in fact, as Mr. Justice Shientag has stated, "the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations." *Bayer* v. *Beran*, 49 N. Y. S. 2d 2, 4 (Sup. Ct. N. Y. Co. 1944). And it is not only the sole remedy for the stockholders but for the corporation itself. For a stockholders' suit lies only when a corporation, because it is controlled by the wrongdoers or for other reasons, fails and refuses to take appropriate action for its own protection. *United Copper Sec. Co.* v. *Amalgamated Copper Co.*, 244 U. S. 261, 263-64 (1917); Federal Rules Civil Procedure, Rule 23. The corporation thus has, by hypothesis, a valid cause of action against its faithless fiduciaries; it has the right to such judicial relief; but the right is only theoretical since those in control of the corporation will not enforce it and it must ultimately be barred by limitations. Unless a stockholder can intercede by derivative action, the corporation's right is nullified as though all right to relief were denied to the corporation in so many words.

This traditional remedy has always been available to the small as well as the large stockholder. As Mr. Chief Justice Hughes stated in *Ashwander* v. *Tennessee Valley Authority*, 297 U. S. 288, 318 (1936), "While their stockholdings are small, they have a real interest and there is no question that

the suit was brought in good faith. If otherwise entitled, they should not be denied the relief which would be accorded to one who owned more shares."

It is against this background that the constitutionality of Chapter 131, destroying the effectiveness of stockholders' suits, must be considered.

B. The History of Chapter 131.

Chapter 131 was "expressly patterned" after Section 61-b of the New York General Corporation Law, enacted a year before. Note (1947) 1 Rutgers U. L. Rev. 117; *Cohen* v. *Beneficial Industrial Loan Corporation*, 170 F. 2d 44, 50-51 (3d Cir., 1948). To the extent that it differs from the New York legislation, it is more severe. It is expressly retroactive, and it requires, for exemption from its provisions, a plaintiff to have securities having a market value in excess of $50,000 or at least five per cent "of the aggregate par value or stated value of all of the outstanding shares of such corporation's stock of every class." Section 61-b is not retroactive[9] and permits a plaintiff to be exempted who has securities having a market value in excess of $50,000 or at least five per cent "of the outstanding shares of any class of such corporation's stock or voting trust certificates * * *."

For all other purposes, however, and so far as they bear upon the case at bar, the New York and New Jersey statutes are identical, and the history of the former is the history of the latter.

That history is as relevant to this legislation as the legislative history was to the statute held unconstitutional in *United States* v. *Lovett*, 328 U. S. 303 (1946). The lack of deliberation and the pressures exerted have been excellently described by Zlinkoff, *The American Investor and the Constitutionality of Section 61-b of the New York General Corporation Law* (1945) 54 Yale L. J. 352, and by Hornstein,

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[9] It was construed as prospective in operation in *Shielcrawt* v. *Moffett*, 294 N. Y. 180 (1945), in order to avoid the constitutional invalidities of retroactive legislation.

The Death Knell of Stockholders' Derivative Suits in New York (1944) 32 Calif. L. Rev. 123, 126. It is sufficient to say that the legislation was copied after recommendations made by a special committee of the Chamber of Commerce of the State of New York. Wood, Survey and Report Regarding Derivative Suits (1944). That report, made without public hearing and under private auspices, has been analyzed in both the Zlinkoff and Hornstein articles. At the risk of understatement it is of questionable accuracy and its lack of fairness is beyond dispute.

C. Equal Protection of the Laws.

That the legislation at issue was not a bona fide attempt to remedy the abuses of derivative suits is quickly revealed on the face of the legislation itself:

1. Chapter 131 requires security from small stockholders but not from large. A stockholder whose shares constitute less than five per cent of the corporation's stock and have a value of less than $50,000 is subject to the statute. But one holding more than five per cent or $50,000 worth of stock is exempt.

2. Chapter 131 imposes possible liability for attorneys' fees and expenses on small stockholders but not on large. In this respect too, a stockholder whose shares constitute less than five per cent of the corporation's stock and have a value of less than $50,000 is subject to the statute. But one holding more than five per cent or $50,000 worth of stock is exempt. *Isensee* v. *Long Island Motion Picture Co.*, 184 Misc. 625, 54 N. Y. S. 2d 556 (Sup. Ct. Queens Co. 1945).

No basis in law or in fact is available to support this classification and none has ever been suggested. The Wood report did not contain any facts justifying a distinction between stockholders owning less than five per cent or less than $50,000 and stockholders owning greater amounts. The report merely assumed that stockholders who had less than five per cent or $50,000 worth of securities in "publicly held corporations" had "stockholdings * * * too small to indicate legitimate personal interest in the outcome."

But neither in the Wood report nor elsewhere are there any statistics or factual data or, indeed, philosophic speculations which would demonstrate that stockholders holding less than five per cent or $50,000 in value have no legitimate interest in their corporation or in the outcome of a derivative suit on behalf of their corporation.

Indeed, experience is exactly to the contrary. The overwhelming majority of all shareholders in publicly owned corporations have small holdings. Berle and Means, The Modern Corporation and Private Property (1932) 47-48; T. N. E. C., Monograph 29, The Distribution of Ownership in the 200 Largest Non-Financial Corporations (1940) 69 ff. 623 ff. The fraud or dereliction of those in control injures the small shareholder proportionally as much as the large shareholder is injured. The classification of the statute, if based upon financial interest, is arbitrary.

Nor is the 5%—$50,000 line justified by any facts demonstrating that strike suits are brought only by stockholders owning lesser amounts. As one commentator stated, "There is * * * no evidentiary support for an assumption that derivative suits brought by those holding $50,000 worth of stock or 5% thereof are more meritorious or brought in better faith than those brought by stockholders owning lesser amounts of shares or that more suits of this character are brought in bad faith by small stockholders than by larger stockholders." Zlinkoff, *The American Investor and the Constitutionality of Section 61-b of the New York Corporation Law* (1945) 54 Yale L. J. 352, 386. Or in the words of another writer "a legislative holding that a small shareholder's suit is presumptively a 'strike' suit not only finds no factual basis but constitutes a type of class legislation that is arbitrary, antisocial and Hamiltonian in its economic shortsightedness." Jackson, *Reorganization of the Corporate Concept and the Effect of Section 61-b of the New York General Corporation Law* (1944) 45 Corp. Reorg. & Amer. Bank. Rev. 323, 340.

In short, Chapter 131 is not motivated either by a legitimate differentiation between the stock of a large and small

stockholder nor by the abuses of stockholders' suits. One might understand requiring the small stockholder alone to give security; one cannot understand subjecting the small stockholder alone to possible liability for attorneys' fees and expenses. One could also understand imposing liability for attorneys' fees and expenses on all those who brought suits without good cause being shown. See *Lowe v. Kansas*, 163 U. S. 81 (1896); Section 11(e) of the Securities Act of 1933 as amended, 11 U. S. C. § 77(k)(e). But one cannot understand imposing possible liability only on small stockholders.

In truth, the statute at bar proceeds on an assumption that only the wealthy or the large stockholder, who, if he is not identical with management, is often allied with it, can be interested in his corporation's affairs. The wealthy or large shareholder may bring stockholder suits, legitimate or otherwise, without putting up security and without being subjected to possible liability. As such it violates the canons of equal protection long stated by this Court. What was said in *Gulf, C. & S. F. R. Co. v. Ellis*, 165 U. S. 150, 155 (1897), has the same pertinence today as when it was written:

> "The State may not say all white men shall be subjected to the payment of the attorneys' fees of parties successfully suing them, and all black men not. It may not say that all men beyond a certain age shall be alone thus subjected, *or all men possessed of a certain wealth*. These are distinctions which do not furnish any proper basis for the attempted classification." (Emphasis added.)

Never once in the history of this Court has a classification based as is this on wealth alone been sustained. In all the cases where state statutes imposing attorneys' fees as part of a recovery have been sustained, as against a claim of equal protection, none is to be found where a classification was based on the total or partial wealth of either of the parties. *Atchison, T. & S. F. R. Co. v. Matthews*, 174 U. S.

96 (1899); *Fidelity Mutual Life Ass'n v. Mettler*, 185 U. S. 308 (1902); *Farmers & M. Ins. Co. v. Dobney*, 189 U. S. 301 (1903); *Seaboard Air Line R. Co. v. Seegers*, 207 U. S. 73 (1907); *Missouri, K. & T. R. Co. v. Cade*, 233 U. S. 642 (1914); *Missouri K. & T. R. Co. v. Harris*, 234 U. S. 412 (1914); *Missouri Pac. R. Co. v. Larabee*, 234 U. S. 459 (1914); *Chicago & N. W. R. Co. v. Nye Schneider Fowler Co.*, 260 U. S. 35 (1922); *Sioux County v. National Surety Co.*, 276 U. S. 238 (1928); *Doherty v. Rogers*, 281 U. S. 362 (1930); *Life & Casualty Ins. Co. v. McCray*, 291 U. S. 566 (1934). Indeed, in the one instance where the classification came near to being based upon wealth, this Court unanimously held unconstitutional a state statute awarding attorneys' fees. *Atchison, T. & S. F. R. Co. v. Vosburg*, 238 U. S. 56 (1915).

D: Due Process of Law.

N. J. R. S. Cum. Supp. 14:3-15 and 14:3-17 violate both the procedural and substantive aspects of the due process clause of the Fourteenth Amendment. Procedurally, these provisions unreasonably qualify—and in effect deny—access by certain plaintiffs to the courts for legal wrongs. Substantively, the legislation violates the due process clause by imposing arbitrary impediments, without reasonable relation to any existing abuses.

1. *Procedural Due Process:* The State of New Jersey has not attempted in terms to exonerate corporate directors and officers from liability for their defalcations involving property of corporations they control. Nor in terms has it forbidden stockholders holding less than five per cent of the outstanding stocks or stocks worth $50,000 or less from bringing suit on behalf of the corporation to remedy such defalcations. But the provisions of New Jersey law, here involved, accomplish these ends as effectively as if such legislation had been passed. No plaintiff, unless he have tremendous resources, can afford to give security in the amount which the statute indicates. Nor certainly will he

litigate difficult questions of corporate law when, in the event he loses, he must pay expenses and counsel fees of the corporation and the individual defendants. For apart from the expenses other than counsel fees, "It is not unusual nor would it be unreasonable for defendants in such actions to retain distinguished counsel. Stockholders' actions are ordinarily directed against several defendants, each of them entitled to counsel of his own choice. The anticipated aggregate charge of several prominent law firms for services in a protracted and intricate litigation are bound to be formidable." *Citron* v. *Mangel Stores Corp.*, 50 N. Y. S. 2d 416, 419 (Sup. Ct. N. Y. Co. 1944).

The effect of Chapter 131 is to place upon the plaintiff the possibility of an enormous liability when there is no possibility of a commensurate reward. The plaintiff can recover nothing for himself; yet if he loses, he may have to pay enormous costs. This is not equal treatment; it is not fair treatment. It gives the opportunity to erect a barrier against suit to the very persons accused of fiduciary delinquency, and it places a premium on dilatory tactics by imposing on plaintiffs the expense of such tactics in the event the case is lost. In the language of Mr. Justice Cardozo it creates "an unfair barrier against the endeavor of an honest litigant to obtain the judgment of a court. In that event, the Constitution intervenes and keeps the court room open." *Life & Casualty Ins. Co.* v. *McCray*, 291 U. S. 566, 574-75 (1934). Constitutional rights may be nullified quite as readily and completely by procedural obstructions to their effective assertions and maintenances as by outright substantive denial. In order to be constitutional, a penalty or stimulus "in the form of attorneys' fees" "must be moderate and reasonably sufficient to accomplish their legitimate object * * *. [T]he imposition of penalties or conditions that are plainly arbitrary and oppressive and 'violate the rudiments of fair play' insisted on in the Fourteenth Amendment, will be held to infringe it." *Chicago & N. W. R. Co.* v. *Nye Schneider Fowler Co.*, 260 U. S. 35, 44 (1922).

Respondent seeks security in the sum of $125,000. No comparable sum was involved in any of the attorneys fees cases decided by the Supreme Court. A statutory fine of $5,000 was stricken down in *Ex parte Young*, 209 U. S. 123 (1908), as foreclosing access to the court: Liquidated damages of $500 were held unconstitutional for the same reason in *Missouri Pac. R. Co.* v. *Tucker*, 230 U. S. 340 (1913). The $125,000 security, or any sizeable portion thereof is so clearly and unmistakably prohibitive as to make further analysis of the authorities superfluous.

For the above reasons, this Court cannot avoid a determination of the constitutionality of this legislation as against the claim that it violates procedural due process, though no actual security has been required of the plaintiffs and though no payment of attorneys' fees or expenses has been demanded.[10] It is settled doctrine ever since *Ex parte Young*, 209 U. S. 123 (1908) that the deterrents to judicial action may be so great as themselves to be unconstitutional. In such cases it is not necessary to subject oneself to the penalizing deterrent. *Ex parte Young, supra; Oklahoma Operating Co.* v. *Love*, 252 U. S. 331 (1920); *Wadley Southern R. Co.* v. *Georgia*, 235 U. S. 601 (1915); *Southwestern Tel. Co.* v. *Danaher*, 238 U. S. 482 (1915); *Missouri Pac. R. Co.* v. *Tucker*, 230 U. S. 340 (1913). See *Petroleum Exploration, Inc.* v. *Public Service Commission*, 304 U. S. 209, 218-219 (1938). Just how great the deterrent is appears from the fact that the defendant corporation requested security of not less than $125,000 and from the experience under Section 61-b where the amounts of security required have ranged from $5,000 to at least $75,000. Zlinkoff, *The American Investor and the Constitutionality of Section 61-b of the New York General Corporation Law* (1945) 54 Yale L. J. 352; *Tichner* v. *Andrews*, C. C. H. N. Y. Corp L. Rep ¶10,206. The Wood Report itself shows that the individual defendants' expenses and

[10] In *Lapchak v. Baker*, 298 N. Y. 89 (1948), as the opinion discloses, the Court of Appeals was limited in its jurisdiction upon appeal by the New York Constitution.

counsel fees have frequently exceeded $100,000. Wood, Survey and Report Regarding Derivative Suits (1944) 8. If a plaintiff must post security or pay attorneys' fees and expenses before testing the constitutionality of this legislation, no test will ever be forthcoming. For no plaintiff, who is affected by the statute, will bring a stockholders' action faced by the possibility of such tremendous liability.

2. *Substantive Due Process*: So far as substantive aspect of the due process clause is concerned, the total unreasonableness of the legislation at issue is best demonstrated by the discrepancy between the evils to be cured and the "remedies" adopted by the statute. The principal wrongs that may arise in stockholders' suits are (1) the bringing of a suit without any reasonable basis in order to secure a payment to prevent harassment; (2) the private settlement of suits either to avoid such harassment or to buy off the revelation of the wrongdoing that the action would bring into the open; (3) the large costs that a corporate defendant must incur to defend groundless suits; (4) the large counsel fees awarded; (5) duplicate suits; (6) champerty and maintenance.

The statute, however, makes no distinction between groundless suits and suits based on reasonable grounds; it does not prevent the secret settlements by means of which meritorious suits are prevented from being carried to a successful conclusion or non-meritorious suits are simply bought off by the defendants; it does not provide for the reimbursements of large costs incurred in the defense of a groundless suit unless the plaintiff owns less than a specified amount of stock—a distinction already shown to be arbitary; it says nothing about excessive plaintiff's attorneys' fees; it does not prevent more than one suit based on the same cause of action; it does not regulate the conduct of attorneys or the attorney-client relationship. It is not even the purpose of the statute to require a minimum amount of stock to be represented in the prosecution of the action. The New York decisions reveal that the joinder, after an action has been commenced, by

plaintiffs owning at least the minimum amount of stock required by the statute does not obviate the necessity for the security nor eliminate the potential liability for attorneys fees and expenses. *Baker* v. *MacFadden Publications, Inc.*, 270 App. Div. 440, 59 N. Y. S. 2d 841 (1st Dept., 1946); *Noel Associates, Inc* v. *Merrill*, 184 Misc. 646, 53 N. Y. S. 2d 143, 153 (Sup. Ct. N. Y. Co. 1944); *Weinstein* v. *Behr*, 68 N. Y. S. 2d 199 (Sup. Ct. N. Y. Co. 1947).

The distinction between the alleged bases for the statute and the unstated real premises is further ascertained by the difference between the legislation as enacted and the remedies available to the legislature if its purpose were what it pretends to be. The New Jersey legislature could have subjected all plaintiffs in stockholders' actions to liability for expenses upon a judicial finding of lack of good faith, it could have outlawed secret settlements either by requiring notice to all shareholders or by insisting upon judicial approval. These remedies it could have chosen, in addition to more radical improvements such as granting to an administrative agency powers of scrutiny over corporate transactions and of enforcement of private rights. That it legislated as it did, despite the multiple choices open to it, indicates that the statute was intended, not as a correction of abuses but as a "death knell" of the small stockholders' only remedy for corporate wrongs, an objective which it could not openly seek or achieve without running afoul of the Fourteenth Amendment's due process clause.

It is unnecessary to make nice distinctions as to whether Chapter 131 has taken away property belonging to the stockholder or property belonging to the corporation in whose right he sues. Sufficient is it that the stockholder, owning less than five per cent or $50,000, has been deprived of his only effective remedy against corporate abuse. Although we frankly admit that abuses of the derivative action exist, in the words of Mr. Justice Rosenman, "the stockholders' suit is, at present, the only practical way of permitting the small stockholder to question controlling stockholders and directors" [quoted in *Shielcraft* v. *Moffet*, 49 N. Y. S. 2d 64, 71

(Sup. Ct. N. Y. Co. 1944). Indeed, this Court, as long ago as 1882, recognized that

> "The exercise of this power in protecting the stockholder against the frauds of the governing body of directors or trustees, and in preventing their exercise, in the name of the corporation, of powers which are outside of their charters or articles of association, has been frequent, and is most beneficial and is undisputed." *Hawes v. Oakland*, 104 U. S. 450, 452 (1882).

We contend that the state may not destroy this sole remedy[11] without providing some substitute. It is unnecessary to explore the uncharted areas of constitutional law as to the power of a state to abolish particular rights of action, such as trespass or slander. See *Honfgarn* v. *Mark*, 274 N. Y. 22 (1937). For whatever the power of the state may be to modify or repeal remedies and whatever its power to abolish rights, "recognized by the common law, to attain a permissible legislative object" *Silver* v. *Silver*, 280 U. S. 117, 122 (1929), certainly a state may not deny to some the power to enforce a right it permits others to enforce.

On two grounds, therefore, this statute is violative of substantive due process. It is completely unrelated to the abuses at hand. It destroys for some, but not for all, the only remedy to enforce rights which the laws of New Jersey, and indeed the statute itself, recognizes.

E. Full Faith and Credit.

In so far as N. J. R. S. Cum. Supp. 14:3-15 and 15:3-17 apply to actions by residents of other states on behalf of foreign corporations, they violate the full faith and credit clause of the federal Constitution and are an attempt by the State of New Jersey to affect relationships in which it has

[11] Even if the visitatorial power of the State or the processes of the criminal law were effective checks upon corporate abuses, which they cannot be, they would be unavailing to return to a corporation money taken from it.

no interest and over which it has no control. They create the very barriers which "it has been the whole course of our law to break down * * * against calling corporations to account in all states where they may do wrong in doing business." Mr. Justice Reed dissenting in *Koster* v. *Lumbermen's Mutual Casualty Co.*, 330 U. S. 518, 538 (1947).

Since Beneficial is a Delaware corporation, and the question at issue is one of the rights of stockholders against the corporation and of the corporation against stockholders, Delaware law must govern. *Selig* v. *Hamilton*, 234 U. S. 652 (1914); *Converse* v. *Hamilton*, 224 U. S. 243 (1912); *Canada Southern R. R.* v. *Gebhard*, 109 U. S. 527 (1883); *Upson* v. *Otis*, 155 F. 2d 606 (2d Cir., 1947); Restatement, Conflict of Laws (1934) § 183; 2 Rabel, The Conflict of Laws (1947) 3.

Under that law a stockholder may bring a derivative suit on behalf of his corporation without putting up security and being subjected to liability for the defendant and attorneys' fees. He must, however, have been a stockholder at the time of the transaction complained of. Delaware Corporation Law, § 51-a.

For purposes of the full faith and credit clause, it makes no difference that Delaware law on the subject has not been reduced to statutory form.[12] It is elementary, of course, that

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[12] In Delaware, the law permitting stockholders' derivative suits is of decisional origin. Nevertheless it might be said that, for purposes of the full faith and credit clause, the common law of Delaware is of statutory character, since it rests upon the reception clause of Delaware's Constitution. See *Tennessee Coal, I. & R. Co.* v. *George*, 233 U. S. 354, 361 (1914). Art. I, § 25, of the Delaware Constitution of 1776 provided:

> "The Common Law of England as well as so much of the statute law as have been heretofore adopted in practice in this State, shall remain in force, unless they shall be altered by a future law of the Legislature * * *."

This provision was, in effect, continued by Art. XVI, § 18, of the Delaware Constitution of 1897, now in force, which provides:

> "All the Laws of this State existing at the time of this Constitution shall take effect, and not inconsistent with it shall remain in force, except so far as they shall be affected by future laws."

See *Wilmington Housing Authority* v. *Fidelity & Deposit Co. of Maryland*, 47 A. 2d 524, 530 (Sup. Ct. Del., 1946, dissenting opinion).

the statutes of a foreign state are its "public acts" and, as such, are entitled to full faith and credit. *Modern Woodmen v. Mixer*, 267 U. S. 544, 551 (1925); *Bradford Electric Light Co. v. Clapper*, 286 U. S. 145, 154-55 (1932); *Broderick v. Rosner*, 294 U. S. 629, 644 (1935). But the same is true of a foreign state's decisional law, as this Court has recognized: "the faith and credit * * * to which local common and statutory law is entitled under the Constitution." *Magnolia Petroleum Co. v. Hunt*, 320 U. S. 430, 436 (1943). For "the law of a state is embodied as well in its common-law rules as in its statutes". *Id.* at 445; Jackson, *Full Faith and Credit—The Lawyer's Clause of the Constitution* (1945) 45 Col. L. Rev. 1, 12; Cheatham, *Res Judicata and the Full Faith and Credit Clause* (1944) 44 Col. L. Rev. 330, 333. Any question about this has been resolved in *Aetna Life Ins. Co. v. Dunken*, 266 U. S. 389, 393, 399 (1924); where the full faith and credit clause was held to require the subordination of the *lex fori* to the unwritten laws of the state where the contract in suit had been made, and in *Order of United Commercial Travelers v. Wolfe*, 331 U. S. 586 (1947), where a statute of the forum was required to yield to the unwritten laws of the state where the corporate defendant was organized.

Under the full faith and credit clause, New Jersey cannot constitutionally enforce Chapter 131 in this case, if Delaware is "competent to legislate" concerning the subject matter and if "of the conflicting interests involved those of the foreign state are superior to those of the forum". *State Farm Mutual Automobile Ins. Co. v. Duel*, 324 U. S. 154, 160 (1945); *Pink v. A. A. A. Highway Express Co., Inc.*, 314 U. S. 201, 209-11 (1941); *Pacific Employers Ins. Co. v. Industrial Accident Commission*, 306 U. S. 493, 501 (1939). Conflicting state policies must be reconciled, "not by giving automatic effect to the full faith and credit clause, compelling the courts of each state to subordinate its own statutes to those of the other, but by appraising the governmental interests of each jurisdiction, and turning the scale of decision according to their weight". *Alaska Packers Assn. v. Industrial Accident*

Commission, 294 U. S. 532, 547 (1935). Similar rules flow from the due process clause. *Home Ins. Co.* v. *Dick*, 281 U. S. 397 (1930); *Hartford A. & I. Co.* v. *Delta & Pine Land Co.*, 292 U. S. 143 (1934).

The subject matter here involved is a corporation's right to reimbursement of its litigation expenses by an unsuccessful stockholder-plaintiff. Which state, New Jersey or Delaware, is "competent to legislate" thereon? Which state, New Jersey or Delaware, has governmental interests therein "superior" to those of the other?

We submit that Delaware has the superior interest. The legal incidents of membership in a corporation are governed by the laws of the state in which the corporation is organized. *Modern Woodmen* v. *Mixer*, 267 U. S. 544, 551 (1925); *Broderick* v. *Rosner*, 294 U. S. 629, 643-44 (1935). It is the state of incorporation which determines, as it must and should, the legal relationship between the stockholder, the officers, the directors, and the corporation itself. If this were not the case, any state in which a corporation did business could modify the charter. See *Canada Southern R. R.* v. *Gebhard*, 109 U. S. 527 (1883).

If statutes such as Chapter 131 are substantive for purposes of *Erie R. R.* v. *Tompkins*, the state should not be permitted to impose upon the federal courts irrational conflict of laws rules. *Klaxon Co.* v. *Stentor Electric Manufacturing Co.*, 313 U. S. 487, 496 (1941), was careful to note that a state's conflict of laws policies must be "within the limits permitted by the Constitution." New Jersey has departed from those limits by denying stockholders of a Delaware corporation the rights given by Delaware law and by imposing upon them penalties and liabilities not imposed by Delaware law. The analogy to *Broderick* v. *Rosner*, 294 U. S. 629 (1935), is a very close one. In that case, New Jersey attempted by statute to bar an action, brought by the Superintendent of Banks of New York, against New Jersey residents, who were stockholders in the Bank of the United States, to recover assessments levied by him in accordance with the law of New York, where the banking corporation had been organized.

Mr. Justice Brandeis for the Court held that the New Jersey law could not govern. As he stated, "Obviously recognition could not be accorded to a local policy of New Jersey, if there really were one; of enabling all residents of the State to escape from the performance of a voluntarily assumed statutory obligation, consistent with morality * * *." 294 U. S. at 644.

V. THE RETROACTIVE APPLICATION OF N.J.R.S. CUM. SUPP. 14:3-15, IN ACCORDANCE WITH THE TERMS OF N.J.R.S. CUM. SUPP. 14:3-17, VIOLATES THE FEDERAL CONSTITUTION.

The retroactive application of the provisions of Chapter 131, here at issue, since they would effectively destroy the sole remedy of the stockholder to rectify defalcations of officers and directors, violates the due process clause of the Fourteenth Amendment and the impairment of contract clause of the federal Constitution.

As a result of the serious constitutional questions which would otherwise have arisen, the New York courts construed Section 61-b as being prospective in operation only. *Shielcraft* v. *Moffett*, 294 N. Y. 180 (1945). See the dissenting opinion of Justice Callahan in *Shielcraft* v. *Moffett*, 268 App. Div. 352, 51 N. Y. S. 2d 188 (1st Dept., 1944). Unfortunately, these same questions cannot be so avoided here. The New Jersey statute was made expressly retroactive and thus although not enacted until 1945, affects this suit which was commenced in 1943.

It has frequently been held by this Court that the Fourteenth Amendment, although it does not protect any particular form of remedy, does guarantee the preservation of a "substantive right to redress" a pre-existing cause of action "by some effective procedure." *Gibbes* v. *Zimmerman*, 290 U. S. 326, 332 (1933); *Ettor* v. *Tacoma*, 228 U. S. 148 (1913). But "statutes which take away every remedy for past wrongs, as distinguished from statutes which merely change the remedy, are condemned as unconstitutional," Cardozo, *J.* in

Jacobus v. *Colgate*, 217 N. Y. 235, 241 (1916). *Forbes Pioneer Boat Line* v. *Board of Commissioners*, 258 U. S. 338, 339, 340 (1922) is wholly applicable to this case.

> "Stripped of conciliatory phrases the question is whether a state legislature can take away from a private party a right to recover money that is due when the act is passed."
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> * * * * * *
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> "Defendant owed the plaintiff a definite sum of money that it had extorted from the plaintiff without right. It is hard to find any ground for saying that the promise of the law that the public force shall be at the plaintiff's disposal is less absolute than it is when the claim is for goods sold."

Mr. Justice Holmes' words would be governing at bar even if this litigation had not been actually instituted two years prior to the enactment of the legislation in question. But the fact that New Jersey is attempting to apply its statutes not only to pre-existing causes of action but to pre-existing suits on such causes of action appears to make this case unique.[13] See Stimson, *Retroactive Application of Law—A Problem in Constitutional Law* (1939) 38 Mich. L. Rev. 39, Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence* (1936) 20 Minn. L. Rev. 775. In no case which we have found has a state been permitted effectively to deprive a party of a private cause of action upon which suit had already been brought.

What is true of the due process clause is also true of the contract clause. Article 1, Section 10 also prohibits the

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[13] The two Supreme Court cases cited by the Court of Appeals are not relevant. *Western Union Telegraph Co.* v. *Louisville & Nashville R. Co.*, 258 U. S. 13 (1922), held that the State could withdraw a right of condemnation it had conferred on telegraph companies. The statute was held applicable to a pending suit on the express ground that it involved "an exertion of power in the public interest of which the companies are the instruments or agents." *Blount* v. *Windley*, 95 U. S. 173 (1877), held constitutional the application of a North Carolina set-off statute to a judgment already obtained. Thereby multiplicity of suits was avoided, and no substantive rights were diminished.

application of Chapter 131 to a pending suit. The petitioner's relationship with the respondent was, of course, contractual. Although not expressly part of that contract, *Myer* v. *Myer*, 271 App. Div. 465, 66 N. Y. S. 2d 83 (1st Dept., 1946), aff'd 296 N. Y. 979 (1947), implicit in it was the unqualified right given them by Delaware law to bring a derivative action; for "the laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in its terms." *Van Hoffman* v. *Quincy*, 4 Wall. 535, 550 (1867), quoted in *Wood* v. *Lovett*, 313 U. S. 363, 370 (1941). The law so incorporated may be non-statutory as well as statutory. *Bronson* v. *Kenzie*, 1 How. 311, 319 (1843).

The plaintiffs' contract with their corporation has been impaired as surely as were the creditors' rights in *Coombes* v. *Getz*, 285 U. S. 434 (1932) and *Hathorn* v. *Calef*, 2 Wall. 10 (1865).

CONCLUSION.

The Court of Appeals for the Third Circuit erred in taking jurisdiction of the appeal from the District Court's interlocutory order; the issues could be raised neither by direct appeal nor by mandamus. It was also in error in holding that Chapter 131 was applicable in the federal courts and in sustaining the constitutionality of this New Jersey legislation. Thus, for the reasons heretofore stated, the Court should reverse the judgment of the Court of Appeals in No. 442 and affirm the judgment in No. 512.

Respectfully submitted,

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APPENDIX A.

Statutes Involved.

Chapter 131 of the New Jersey Laws of 1945 (N. J. R. S. Cum. Supp. 14:3-15, 14:3-17) provides as follows:

> "In any action instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of shares, or of voting trust certificates representing shares, of such corporation having a total par value or stated capital value of less than five per centum (5%) of the aggregate par value or stated value of all the outstanding shares of such corporation's stock of every class, exclusive of shares held in the corporation's treasury, unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars ($50,000.00), the corporation in whose right such action is brought shall be entitled, at any stage of the proceeding before final judgment, to require the complainant or complainants to give security for the reasonable expenses, including counsel fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which it may become subject pursuant to law, its certificate of incorporation, its by-laws or under equitable principles, to which the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of such security may thereafter, from time to time, be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive.
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> * * * * *

"This act shall take effect immediately and shall apply to all such actions, suits or proceedings now pending in which no final judgment has been entered, and to all future actions, suits and proceedings."

28 U. S. C. § 1291 Provides as follows:

"The courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States, the District Court for the Territory of Alaska, the United States District Court for the District of the Canal Zone, and the District Court of the Virgin Islands, except where a direct review may be had in the Supreme Court."

28 U. S. C. § 1651 (a) provides as follows:

"The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions agreeable to the usages and principles of law."

28 U. S. C. § 1652 provides as follows:

"The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

Rule 23 of the Federal Rules of Civil Procedure provide as follows:

"(a) Representation. If persons constituting a class are so numerous as to make it impracticable to bring them all before the court, such of them, one or more, as will fairly insure the adequate representation of all may, on behalf of all, sue or be sued, when the character of the right sought to be enforced for or against the class is

(1) joint, or common, or secondary in the sense that the owner of a primary right refuses to enforce that right and a member of the class thereby becomes entitled to enforce. * * *

"(b) Secondary Action by Shareholders. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because that association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

"(c) Dismissal or Compromise. A close action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. * * *"

APPENDIX B.

SCHEDULE OF RECOVERIES OF MORE THAN $25,000 IN STOCKHOLDERS' DERIVATIVE ACTIONS INVOLVING PUBLICLY OWNED CORPORATIONS.*

Price v. *Crede Petroleum Corp.*, N. Y. L. J. 5/13/47 p. 1878, col. 3	$23,000,000
Perrine v. *Pennroad Corp.*, 43 A. 2d 479 (Del. Ch., 1945)	15,000,000
Johnson v. *Western Union Telegraph Co.* (Gold & Stock Tele Co.), 185 Misc. 728, 53 N. Y. S. 2d 867 (S. Ct. 1945) (est.)	8,000,000
Mann v. *Hearst*, Superior Ct., Los Angeles Co., Cal. Index No. 432229 (Judg. 11/10/41)	5,022,258
Winkelman v. *Gen'l Motors Corp.*, U. S. D. C., S. D. N. Y. 84221/1936	4,500,000
Shanik v. *Empire Power Corp.*, Index No. 8634/1945	4,261,684
Rosenak v. *Lucas* (Diamond Match Co.), Index No. 27467/1946 (est.)	4,250,000
Bookbinder v. *Chase Nat'l Bank*, Index No. 42665/1933	2,500,000
Posen v. *Cowdin* (Universal Pictures Corp.), Index No. 33135/1940, N. Y. L. J. 6/3/43, p. 2164, col. 6	2,000,000
Loreman v. *Loft, Inc.*, Index No. 3392/1940	1,968,487
Gallin v. *Nat'l City Bank*, Index No. 8297/1933	1,847,943

* The schedule, not intended to be complete, has been compiled largely from data set forth in Appendix D of the *Survey and Report Regarding Stockholders' Derivative Suits* (1944), prepared by the Chamber of Commerce of the State of New York; Hornstein, *Problems of Procedure in Stockholders' Derivative Suits* (1942) 42 Col. L. Rev. 574, 587; and Hornstein, *New Aspects of Stockholders' Derivative Suits* (1947) 47 Col. L. Rev. 1, 16-17.

Except where otherwise indicated index numbers are those of the New York County Clerk.

Heller v. *Boylan* (Amer. Tob. Co.), Index No. 11877/1939	1,809,935
Bysheim v. *Miranda* (Brewster Aero. Corp.), 45 N. Y. S. 2d 473 (S. Ct., 1943)	1,800,000
Donovan v. *Atlas Corp.*, Index No. 34032/1934	1,500,000
Weiss v. *Gen'l Inv. Co.*, Index No. 31607/1937	1,375,000
Phillips v. *Cities Service Co.*, U. S. D. C., S. D. N. Y., 77-6/1933	1,250,000
Cwerdinski v. *Bent* (Bethlehem Steel Corp.), Index No. 30271/1937	1,105,821
Druckerman v. *Harbord* (Radio Corp of America), Index No. 31307/1938	1,000,000
Kalmanash v. *Smith* (Certainteed Products Corp.), N. Y. L. J. 5/13/44, p. 1869, col 6 (est.)	1,000,000
Murphy v. *North Amer. L. & P. Co.*, U. S. D. C., S. D. N. Y., 85-335/1937 (est.)	900,000
Litwin v. *Allen* (Guar. Trust Co.), Index No. 2418/1938	750,000
Diamond v. *Davis* (U. S. Rubber Co.), 62 N. Y. S. 2d 175 (S. Ct., 1945) (est.)	750,000
U. S. Lines Inc. v. *U. S. Lines Co.*, U. S. D. C., S. D. N. Y. 57195/1934	750,000
Fleishhacker v. *Blum* (Anglo-California Bank of San Francisco), 109 F. 2d 543 (9th Cir., 1940)	736,485
Benedict v. *Seagrave* (Insuranshares Corp.), Index No. 45607/1933	723,500
Bing v. *Consolidated Oil Corp.*, Index No. 34356/1936	675,000

Neuberger v. *Barrett* (Union Carbide & Carbon Corp.), 180 Misc. 222, 39 N. Y. S. 2d 575 (S. Ct., 1942)	(est.)	653,000
Andrews v. *Hupp Motor Co.*, Index No. 20878/1934		612,500
Cohen v. *Macfadden* (Macfadden Publications, Inc.), Index No. 13724/1940		550,000
Epstein v. *Schenck* (Loew's, Inc.), Index No. 3033/1938		527,802
Weiss v. *Coe* (Brooklyn Union Gas Co.), Index No. 2204/1941		476,549
Chelrob, Inc. v. *Barrett* (Queensboro Gas & Elec. Co.), 185 Misc. 305, 56 N. Y. S. 2d 628 (S. Ct., 1945)		470,854
Steinberg v. *Mitchell* (Electric Bond & Share Co.), Index No. 26739/1932		400,000
Gans v. *Hearst*, Index No. 15968/1938		400,000
Wilkay Corp. v. *Goldman-Sachs Trading Corp.*, Index No. 3363/1932		385,000
Blank v. *Sams* (J. C. Penney Co.), Index No. 20382/1944		330,000
Adams v. *Lang* (Crocker Wheeler Corp.), Index No. 29185/1936		325,000
Streicher v. *Utility & Ind. Corp.*, U. S. D. C., S. D. N. Y. 87126/1938		275,000
Garsson v. *Nat'l Rubber Mach. Co.*, Index No. 25826/1939		245,000
Sarasohn v. *Andrew Jergens Co.*, 45 N. Y. S. 2d 888 (S. Ct., 1943)	(est.)	210,000
Shielcrawt v. *Moffett* (Corn Products Ref. Co.), Index No. 14134/1940		204,341
Gray v. *Burco, Inc.*, Index No. 14912/1938		200,000

Roth v. *Abrons* (Gen. Realty & Ut. Corp.), Index No. 94/1942	160,000
Becber v. *Empire Power Co.*, Index No. 25012/1937	150,000
Naitove v. *Morrow* (Hecker Products Corp), Index No. 8843/1939	130,000
Said v. *Eitington Schild Co., Inc.*, Index no. 25484/1935	100,000
Baumgold v. *Bailey* (Title Guar. & Trust Co.), Kings Co. Clerk's Index No. 148/1942	80,000.
Smith v. *Loft, Inc.* (Happiness Candy Stores, Inc.), Index No. 20305/1941	75,000
Lesire Corp. v. *Amer. Com'l. Alcohol Co.*, Index No. 27589/1935	70,000
Jules Mar. Inc. v. *Com'l. Credit Co.*, Index No. 20742/1941	60,000
Caulfield v. *Amer. Founders Co.*, Index No. 45610/1933	60,000
Hagenbusch v. *Am. Ber. Co.*, Index No. 14931/1942	50,000
Harris v. *Fenner* (Croft Brewing Co.), Index No. 4751/1938	50,000
May v. *Interstate Hosiery Mills, Inc.*, Index No. 27887/1938	34,000
Mason v. *Richardson* (Columbia Broadcasting Co.), Index No. 1534/1941	32,500
Berger v. *Allen* (Empire Trust Co.), Kings Co. Clerk's Index No. 7205/1942	25,000
Martin v. *United Standard Oil Fund of America*, U. S. D. C., S. D. N. Y. 86-175/1937	25,000